draft report which SBC contends to be confidential. The BOC's response shall be included as part of the final report.

e. Within ten days after receiving SBC's comments, the practitioner may respond to SBC's comments and shall make available for public inspection the final report by filing it with the regulatory agencies having jurisdiction over SBC. The final report shall contain the procedures employed with the related findings, the Oversight Team's comments, SBC's comments, the practitioner's reply comments, and a copy of these procedures as executed.

f. Interested parties shall have 60 days from the date the report is made available for public inspection to file comments with the Commission and/or any state regulatory agency.

Report Structure

32. Consistent with the AICPA standards for AUP engagements, the practitioner must present the results of performing the audit procedures in the form of findings, including dollar amounts, resulting from application of the audit procedures. The presentation of findings related to each of the specified procedures shall include sufficient detail and specificity that a reader may draw a reasonable conclusion as to whether the respective Objective has or has not been met. The practitioner shall include in the report all the information required to be included in the report by the procedures and any further information required by the Oversight Team subject to the provisions of paragraph 3. The practitioner must avoid vague or ambiguous language in reporting the findings and shall describe in the final report all instances of noncompliance with section 272 or its related implementing rules that were noted by the practitioner in the course of the engagement, or disclosed by SBC during the engagement and not covered by the performance of these procedures. Where samples are used to test data, the report shall identify the size of the universe from which the samples were drawn, the size of the sample, the sampling methodology used and, where appropriate, the standard deviation and mean. The final report shall contain the procedures employed with the related findings, the Oversight Team's comments, SBC's comments, the practitioner's reply comments, and a copy of these procedures as executed. The practitioner's report must also contain the following elements:

a. A title that includes the word independent.

b. Identification of the specified parties.

c. Identification of the subject matter (or the written assertion related thereto) and the character of the engagement.

d. Identification of SBC as the responsible party.

e. A statement that the subject matter is the responsibility of the responsible party, SBC.

f. A statement that the procedures performed were those agreed to by the specified parties identified in the report or as directed by the Bureau or the Commission, as specified in paragraph 3.

g. A statement that the agreed-upon procedures engagement was conducted in accordance with attestation standards established by the AICPA.

h. A statement that the sufficiency of the procedures is solely the responsibility of the specified parties and a disclaimer of responsibility for the sufficiency of those procedures.

i. A list of the procedures performed (or reference thereto) and related findings.

j. A statement that the practitioner was not engaged to and did not conduct an examination of the subject matter, the objective of which would be the expression of an opinion, a disclaimer of opinion on the subject matter, and a statement that if the practitioner had performed additional procedures, other matters might have come to his or her attention that would have been reported.

k. This report becomes a matter of public record via the practitioner's filing the final report with the FCC and the state regulatory agencies having jurisdiction over SBC.

l. A description of any limitations imposed on the practitioner by the BOC/ILEC or any other affiliate, or other circumstances that might affect the practitioner's findings.

m. A description of the nature of the assistance provided by specialists and internal auditors.

SBC COMMUNICATIONS INC.
BIENNIAL ENGAGEMENT PROCEDURES

Follow-up Procedures on the Prior Engagement

1. The following matters were noted in the prior engagement SBC Communications Inc. Section 272 Biennial Agreed Upon Procedures Report of the independent accounting firm, Ernst & Young LLP, dated December 15, 2003:

   a. Documented three instances (involving the lack of seven agreements) where an SBC BOC provided services to a section 272 affiliate without a written agreement (V/VI-4 in the report, V/VI-4a in this program).

   b. Twenty-four (24) affiliate agreements were posted to the Internet more than ten days after their effective date (V/VI-5 in the report, V/VI-5 in this program).

   c. For services tested that were provided by the section 272 affiliates to SBC BOCs (V/VI-7 in the report, V/VI-8 in this program):

      - For nine of 136 services tested, the mark up rates used (or whether a mark-up was used at all) could not be substantiated by SBCS, therefore no determination could be made as to whether these rates were in compliance with the affiliate transaction rules.

      - Rates for four of 136 services billed by SBCS to SBC BOCs were priced at rates different than the lesser of FDC or FMV.

      - Rates for 44 of 233 services tested that were rendered by ACI were higher than the rates supported by FDC or FMV studies provided by SBC. Additionally, for 59 of the 233 services, SBC did not provide FDC or FMV rate studies to support the rates charged; consequently, no determination could be made as to whether the rates billed were in compliance with affiliate transaction rules.

      - Differences noted and/or the inability to agree the amounts per invoice paid by the SBC BOCs and the amount billed by SBCS. For eight of 100 invoices, differences were noted in the paid amounts per invoice provided by the SBC BOC and the amount billed by SBCS. In addition, for 42 of 100 invoices, the payment support provided by the SBC BOC was a listing of check amounts paid by the SBC BOCs to SBCS. Since many of the check amounts were for multiple invoices, the payments of individual SBCS invoices could not be agreed to the check amounts listed on the payment support.

d. For services rendered by the SBC BOCs to the section 272 affiliates (VII-3 in the report, VII-4 in this program):

- The rate charged to an unaffiliated carrier by the Ameritech BOCs on December 2001 billing for "Account Maintenance CIC" was $0.055 per unit compared to $0.045 per unit billed to SBCS.

- For 16 of the 20 SBCS billings, compared the amount billed to SBCS by the SBC BOCs to the amounts paid by SBCS and noted that one invoice was underpaid by $176.87. SBC represented that this payment difference was due to a billing dispute. Payment support for four of the 20 SBCS billings totaling $531.33 used in the above comparison was not provided by SBCS.

- For 15 of the 81 local exchange service rates selected, the rates charged did not agree to the tariffed rates. The rates (by USOC and class of service) charged by the SBC BOCs to the section 272 affiliates are in some cases lower than the tariff rates charged unaffiliated carriers.

- For four of the 25 invoices, payment support was not provided by SBCS.

e. The performance measures (PMs), which are designed to determine compliance with the nondiscriminatory requirements of section 272(e)(1), reveal an erratic pattern of performance, some in favor of the affiliates and some in favor of the nonaffiliates, at different stages of completion of the requests for service (VIII-4 in the report, VIII-4 in this program). In addition, differences were noted in the replication of all PMs except for PM 3 (VIII-5 in the report, VIII-5 in this program).

f. A test of exchange access rates by USOC code reveals that the rates charged by the SBC BOCs to the section 272 affiliates are in some cases lower than the rates charged unaffiliated carriers (IX-2 in the report, IX-2 in this program).

g. A test of invoices for exchange access services revealed differences (for eight out 85 invoices tested) between the amount billed by the SBC BOC and the amount paid by SBCS (IX-3 in the report, IX-3 in this program).

h. SBC represented to the auditor that only SWBT and Pacific Bell impute amounts for access, switching, and transport associated with National Directory Assistance ("NDA"), and that the imputation for NDA was the sole imputation performed by the BOCs. In response to a post-audit inquiry from Commission staff, SBC represented that some small amounts of imputation should have been done for E-911 services, but that these amounts were immaterial and therefore SBC did not book any retroactive adjustments (X-2 in the report, X-2 in this program).

i. Differences were noted between amounts recorded as expense and paid by the section 272 affiliates vs. the amounts booked as revenue by the SBC BOCs for exchange access services and local exchange services provided to the section 272 affiliates (X-3 in the report, X-3 in this program).

j. Subsequent to the audit, SBC represented to the auditor that in Texas, SWBT offered an interLATA T-1 facility to a CLEC instead of offering the interLATA service through SBCS. This violation of an interLATA service offered by the BOC, instead of through a separate affiliate required by section 272(a), went on from August, 2000, through the June 30, 2003, sunset date for Texas (Procedures for Subsequent Events in the report, page 42).

2. When performing the procedures related to the above matters, the practitioner will note in the report whether these matters continued to exist beyond the previous engagement period, what action management took to ensure their non-recurrence or improvement, and the effective date of such action. If no action has been taken, obtain and include in the audit report management's explanation. Note that for this engagement the former SBCS and ACI are now SBCLD.

Procedures for Structural Requirements

OBJECTIVE I. **Determine whether the separate affiliate required under section 272 of the Act has operated independently of the Bell operating company.**

STANDARDS

The FCC has issued rules and regulations in CC No. Docket 96-149, Implementation of the Non-Accounting Safeguards of sections 271 and 272 of the Communications Act of 1934, as amended. Some of those rules require that,

- A BOC and its section 272 affiliate cannot jointly own transmission and switching facilities, broadly defined as local exchange and exchange access facilities, or the land and buildings where those facilities are located. (See 47 C.F.R. section 53.203(a) and First Report and Order, para. 15, 158, 160)

- Prior to March 30, 2004, a section 272 affiliate shall not perform operating, installation or maintenance functions associated with the BOC's facilities. Likewise, prior to March 30, 2004, a BOC or any BOC affiliate, other than the section 272 affiliate itself, shall not perform operating, installation or maintenance functions associated with the facilities that each section 272 affiliate owns or leases from a provider other than the BOC with which it is affiliated. (See 47 C.F.R. section 53.203(a)(2), (3) and First Report and Order, para. 15, 158, 163; see also WC Docket No. 03-228, Report and Order, para. 8, 12, 16, 24, 31)

- To the extent that research and development is a part of manufacturing, it must be conducted through a section 272 affiliate. If a BOC seeks to develop services for or with its section 272 affiliate, the BOC must develop services on a nondiscriminatory basis for or with other entities pursuant to section 272(c)(1). (See First Report and Order, para. 169)

PROCEDURES

1. Inquire of management whether there have been any changes in the certificate of incorporation, bylaws, and articles of incorporation of the section 272 affiliates covered in this biennial audit, and whether there have been any legal and/or "doing business as" (DBA) name changes since the last engagement period. For each such change reported by management, and for any section 272 affiliate established or formed since the last engagement period, inspect the certificate of incorporation, bylaws, and articles of incorporation to determine whether these affiliates were established as corporations separate from the SBC BOC/ILEC. Note in the report the results of this procedure.

2. Obtain and inspect corporate entities' organizational chart(s) and confirm, as appropriate, with legal representatives of the SBC BOC/ILEC, section 272 affiliates, and SBC

Communications Inc., the legal, reporting, and operational corporate structure of the section 272 affiliates. Disclose these facts in the report. Document and disclose in the report who owns the section 272 affiliates.

3. For the period prior to March 30, 2004, inquire of management, identify and document which entity performed operating, installation and maintenance functions over facilities either owned by each section 272 affiliate, or leased from a third party by each section 272 affiliate.

   a.) Obtain management's definition and interpretation of operating, installation, and maintenance (OI&M) functions. Describe in the report management's definition of OI&M.

   b.) For the period prior to March 30, 2004, disclose in the report whether or not any of these above described OI&M services were being performed by the SBC BOC/ILECs and/or other non-section 272 affiliate(s) on facilities either owned by the section 272 affiliate or leased from a third party by the section 272 affiliate(s). For each such OI&M service, disclose in the report what service was being performed by what entity, *e.g.*, name of BOC/ILEC, or name of other non-section 272 affiliate.

   c.) For the period prior to March 30, 2004, disclose in the report whether or not any of these above described OI&M services were being performed by the section 272 affiliate on facilities either owned by SBC BOC/ILECs or leased from a third party by SBC BOC/ILECs. For each such OI&M service being performed by the section 272 affiliate, disclose in the report what service was being performed.

4. As of the end of the engagement period, inquire of management, identify, and document in the report which entity performs operating, installation, and maintenance functions over facilities either owned by each section 272 affiliate, or leased from a third party by each section 272 affiliate.

   a.) Disclose in the report whether or not any of these OI&M services are being performed by the SBC BOC/ILECs and/or other non-section 272 affiliate(s) on facilities either owned by each section 272 affiliate or leased from a third party by a section 272 affiliate. For each such OI&M service, disclose in the report what service is being performed by what entity, *e.g.*, name of BOC/ILEC, or name of other non-section 272 affiliate. Also disclose the date upon which each service was first provided.

   b.) Disclose in the report whether or not any of these OI&M services are being performed by any section 272 affiliate on facilities either owned by SBC BOC/ILECs or leased from a third party by SBC BOC/ILECs. For each such service being performed by a section 272 affiliate, disclose in the report what service is being performed by what entity, the name of the section 272 affiliate, and the date upon which the service was first provided.

5. Inquire of management to determine whether the SBC BOC/ILECs perform any research and development (R&D) activities on behalf of the section 272 affiliates. If yes, obtain descriptions of R&D activities of the SBC BOC/ILEC for the Audit Test Period and note any R&D related to the activities of each section 272 affiliate. For R&D related to the activities of each section 272 affiliate, inquire of SBC BOC/ILEC personnel to obtain more details, such as the extent of R&D provided, progress reports, cost, and whether the section 272 affiliate has been billed and has paid for this service and disclose all results of such inquiries in the report. For R&D services offered by any BOC/ILEC to any section 272 affiliate, inquire and disclose in the report whether R&D service is offered and/or has been performed by the BOC/ILECs when requested by unaffiliated entities.

6. Obtain, as of the end of the Audit Test Period, the balance sheet of each section 272 affiliate and a detailed listing of all fixed assets including capitalized software which agrees with the amount shown in the balance sheet. If the list does not agree, inquire and document why and disclose in the report by what amount the assets in the balance sheet are more than, or less than, as appropriate, the total amount of the assets on the detailed listing. Identify in the report the types of assets involved in these differences and provide explanations. Verify that the detailed listing includes a description and location of each item, date of purchase or acquisition, price paid and recorded, and from what BOC/ILEC or affiliate purchased or transferred (if purchased from a nonaffiliate, then indicate "Nonaffiliate"). Disclose in the report any item, including dollar amounts, where any of this information is missing. Inspect title and/or other documents, which reveal ownership, of a statistically valid sample of transmission and switching facilities, including capitalized software, and the land and buildings where those facilities are located, added since July 10, 2003. If any of these documents are not made available, disclose in the report. Look for and make a note of any facilities that are owned jointly with the SBC BOC/ILEC and disclose in the report. The balance sheet information obtained in this procedure should also be used to perform Procedure 9 under Objectives V and VI.

<u>OBJECTIVE II</u>. Determine whether the separate affiliate required under section 272 of the Act has maintained books, records, and accounts in the manner prescribed by the Commission that are separate from the books, records, and accounts maintained by the Bell operating company.

STANDARDS

In CC Docket No. 96-150, Implementation of the Accounting Safeguards Under the Telecommunications Act of 1996, the FCC requires that each section 272 affiliate maintain books, records, and accounts, in accordance with generally accepted accounting principles (GAAP), and separate from those of the BOC. (See Report and Order, para. 170)

PROCEDURES

1. Obtain the general ledger (G/L) of each section 272 affiliate as of the end of the Audit Test Period and match the title on the G/L with the name of the affiliate on the certificate of incorporation (or other name which uniquely identifies the section 272 affiliate such as the DBA) to determine that a separate G/L is maintained. Look for special codes, if any, which may link this G/L to the G/L of any SBC BOC/ILEC and provide documentation (unless such codes are merely common accounting system codes or the like that are used in the general ledgers of all companies produced by such accounting system). State in the report whether or not a separate G/L is maintained, and if not, explain why. Note: Linkage at corporate headquarters for consolidations is an accepted practice.

2. Obtain each section 272 affiliate's financial statements (i.e., Income Statement and Balance Sheet) as of the end of the Audit Test Period.

3. Obtain a list of lease agreements for each section 272 affiliate as of the end of the Audit Test Period. Identify leases for which the annual obligation listed in the lease agreement is $500,000 or more. Test both leases for which the section 272 affiliate is the lessor and leases for which the section 272 affiliate is the lessee. For a statistically valid sample of leases $500,000 or more, obtain a copy of the lease agreement, and make a note of the terms and conditions. Obtain a copy of each section 272 affiliate's accounting policy related to leases. Compare the accounting of the leases selected above to the section 272 affiliate's accounting policy and to GAAP. Determine whether these leases have been accounted for in accordance with the section 272 affiliate's accounting policy and with GAAP. Disclose in the report any instance where these leases were not accounted for in accordance with GAAP.

<u>OBJECTIVE III</u>. Determine whether the separate affiliate required under section 272 of the Act has officers, directors, and employees that are separate from those of the Bell operating company.

<u>STANDARDS</u>

The FCC in CC Docket No. 96-149, Implementation of the Non-Accounting Safeguards of sections 271 and 272 of the Communications Act of 1934, as amended, interprets the above requirement further by stating the following:

- Separate officers, directors, and employees simply dictates that the same person may not simultaneously serve as an officer, director, or employee of both a BOC and its section 272 affiliate. (See First Report and Order, para. 178)

<u>PROCEDURES</u>

1. Inquire, document and disclose in the report whether each section 272 affiliate and each SBC BOC/ILEC maintain separate boards of directors, separate officers, and separate employees. For each SBC BOC/ILEC and each section 272 affiliate, obtain a list of the names of directors and officers , including the dates of service for each Board member and officer for the engagement period. Confirm this list by comparing it to historical records of consents, minutes of Board of Directors' meetings, etc. Compare the list of names of directors and officers of each SBC BOC/ILEC with the list of names of directors and officers of each section 272 affiliate. For those names appearing on both a BOC/ILEC list and a section 272 affiliate list, obtain explanations from management and request social security numbers and addresses to ensure that they are not the same individuals. Disclose in the report the number of directors and officers (who have the same social security number and address) who served simultaneously as a director and/or officer of any SBC BOC/ILEC and any section 272 affiliate.

2. Obtain from their respective Human Resource Departments a list of names and social security numbers of all employees of each section 272 affiliate and each SBC BOC/ILEC for the engagement period. Run a program which compares names and social security numbers of employees, and document in the workpapers the names appearing on both BOC/ILEC and section 272 lists, respectively. For any employee appearing on both lists simultaneously, inquire and document why in the report (for privacy reasons, do not include the names or SSNs of any SBC employees in the report).

<u>OBJECTIVE IV</u>. Determine that the separate affiliate required under section 272 of the Act has not obtained credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of the Bell operating company.

STANDARDS

The FCC in 47 C.F.R. section 53.203(d) indicates that a section 272 affiliate shall not obtain credit under any arrangement that would permit a creditor, upon default, to have recourse to the assets of the BOC of which it is an affiliate.

The FCC also expands on this premise in CC Docket No. 96-149, Implementation of the Non-Accounting Safeguards of section 271 and 272 of the Communications Act of 1934, as amended. In this docket the Commission states that,

- A BOC cannot co-sign a contract or any other instrument with a section 272 affiliate that would allow each section 272 affiliate to obtain credit granting recourse to the BOC's assets. (See First Report and Order, para. 189)

- The BOC parent, or any other non-section 272 affiliate, cannot sign or co-sign a contract or any arrangement with a section 272 affiliate that would allow the creditor to have recourse to the BOC assets. (See First Report and Order, para. 189)

- A section 272 affiliate cannot enter any arrangement with any party that would permit the lender to have recourse to the BOC in the event of a default. (See First Report and Order, para. 189)

PROCEDURES

1. Document in the workpapers each section 272 affiliate's debt agreements/instruments and credit arrangements with lenders and major suppliers of goods and services. Look for guarantees of recourse to any SBC BOC's/ILEC's assets, either directly or indirectly through another affiliate, and document those instances and disclose in the report. Major suppliers are those having $500,000 or more in annual sales to the section 272 affiliate as stated in the agreement.

2. Using the lease agreements obtained in Objective II, Procedure 3, that were entered into or modified during the Audit Test Period, document any instances in which each section 272 affiliate's lease agreements (where the annual obligation is $500,000 or more as stated in the agreement) have recourse to the assets of any SBC BOC/ILEC, either directly or indirectly through another affiliate, and disclose in the report.

3. For all debt instruments, leases, and credit arrangements maintained by each section 272 affiliate in excess of $500,000 of annual obligations that were entered into or modified

during the engagement period, and for a sample of 10 debt instruments, leases and credit arrangements that are less than $500,000 in annual obligations that were entered into or modified during the engagement period, (judgmental sample), obtain (positive) confirmations from loan institutions, major suppliers, and lessors to attest to the lack of recourse to any SBC BOC/ILEC's assets. Disclose in the report any recourse noted.

Procedures for Accounting Requirements

OBJECTIVE V. Determine whether the separate affiliate required under section 272 of the Act has conducted all transactions with the Bell operating company on an arm's length basis with the transactions reduced to writing and available for public inspection.

OBJECTIVE VI. Determine whether or not the Bell operating company has accounted for all transactions with the separate affiliate in accordance with the accounting principles and rules approved by the Commission.

STANDARDS

The FCC in CC Docket No. 96-150, Implementation of the Accounting Safeguards Under the Telecommunications Act of 1996, interprets the above requirements further by stating:

- A section 272 affiliate shall conduct all transactions with the BOC of which it is an affiliate on an arm's length basis, pursuant to the accounting rules described in 47 C.F.R. section 32.27, Transactions with Affiliates, of the FCC Rules and Regulations, with any such transactions reduced to writing and available for public inspection. (See 47C.F.R.section 53.203(e)). Section 32.27 requires the following:

  For transactions involving the sale or transfer of assets between the carrier and affiliates:

  a. assets sold or transferred between a carrier and its affiliate pursuant to a tariff, including a tariff filed with a state commission, shall be recorded in the appropriate revenue accounts at the tariff rate;

  b. nontariffed assets sold or transferred between a carrier and its affiliate that qualify for prevailing price must be recorded at prevailing price. In order to qualify for prevailing price valuation, sales of a particular asset to third parties must encompass greater than 25% of the total quantity of such product sold by an entity. Carriers shall apply this 25% threshold on an asset-by-asset basis rather than on a product line basis. See "Exceptions" below;

  c. all other assets sold by or transferred from a carrier to its affiliates, the asset shall be recorded at no less than the higher of fair market value or net book cost. See "Exceptions" below;

  a. for all other assets sold by or transferred to a carrier from its affiliates, the assets shall be recorded at no more than the lower of fair market value or net book cost. See "Exceptions" below;

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Exceptions:
Floor. When assets are sold by or transferred from a carrier to an affiliate, the higher of fair market value and net book cost establishes a floor, below which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or greater than the floor, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive.

Ceiling. When assets are purchased from or transferred from an affiliate to a carrier, the lower of fair market value and net book cost establishes a ceiling, above which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or less than the ceiling, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive.

Threshold. Carriers are required to make a good faith determination of fair market value for an asset when the total aggregate annual value of the asset(s) reaches or exceeds $500,000, per affiliate. When a carrier reaches or exceeds the $500,000 threshold for a particular asset for the first time, the carrier must perform the market valuation and value the transaction on a going-forward basis in accordance with the affiliate transactions rules. When the total aggregate annual value of the asset(s) does not reach or exceed $500,000, the asset(s) shall be recorded at net book cost.

For transactions involving the provision of services between the carrier and affiliates:

a. services provided between a carrier and its affiliate pursuant to a tariff, including a tariff filed with a state commission, shall be recorded in the appropriate revenue accounts at the tariffed rate;

b. nontariffed services provided between a carrier and its affiliate pursuant to publicly filed agreements submitted to a state commission pursuant to section 252(e) of the Communications Act of 1934 or statements of generally available terms pursuant to section 252(f) shall be recorded using the charges appearing in such publicly filed agreements or statements;

c. nontariffed services provided between a carrier and its affiliate that qualify for prevailing price valuation shall be recorded at the prevailing price. In order to qualify for prevailing price valuation, sales of a particular service to third parties must encompass greater than 25% of the total quantity of such service sold by an entity. Carriers shall apply this 25% threshold on a service-by-service basis rather than on a service line basis. See "Exceptions" below;

d. all other services sold by or transferred to a carrier from its affiliate shall be recorded at no more than the lower of fair market value and fully distributed cost. See "Exceptions" below;

b. all other services sold by or transferred from a carrier to its affiliate shall be recorded at no less than the higher of fair market value and fully distributed cost. See "Exceptions" below;

Exceptions:
Floor. When services are sold by or transferred from a carrier to an affiliate, the higher of fair market value and fully distributed cost establishes a floor, below which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or greater than the floor, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive.

Ceiling. When services are purchased from or transferred from an affiliate to a carrier, the lower of fair market value and fully distributed cost establishes a ceiling, above which the transaction cannot be recorded. Carriers may record the transaction at an amount equal to or less than the ceiling, so long as that action complies with the Communications Act of 1934, as amended, Commission rules and orders, and is not otherwise anti-competitive.

Threshold. Carriers are required to make a good faith determination of fair market value for a service when the total aggregate annual value of that service reaches or exceeds $500,000, per affiliate. When a carrier reaches or exceeds the $500,000 threshold for a particular service for the first time, the carrier must perform the market valuation and value the transaction on a going-forward basis in accordance with the affiliate transactions rules. When the total aggregate annual value of the service does not reach or exceed $500,000, the service shall be recorded at fully distributed cost.

- Fully distributed cost is determined by following the standards contained in 47 C.F.R. section 64.901, Allocation of Costs, of the FCC Rules and Regulations. These rules emphasize direct assignment and cost causation. First, costs are to be directly assigned either to regulated or nonregulated activities to the maximum extent possible. Then, costs which cannot be directly assigned are to be grouped into homogeneous cost pools and allocated in accordance with direct or indirect measures of cost causation. Residual costs which cannot be apportioned on any cost-causative basis will be apportioned using the general allocator. The general allocator is the ratio of all expenses directly assigned or attributed to nonregulated activities, to the total of all (regulated and nonregulated) directly assigned or attributed expenses.

- A BOC and a section 272 affiliate may provide in-house services to one another, except for the provision of operating, installation, or maintenance services prior to March 30, 2004. These in-house services, however, must be provided on an arm's length basis, and must be in writing. (See CC Docket No. 96-149, First Report and Order, para 180; see also WC Docket No. 03-228, Report and Order, para. 8, 12, 16, 24, 31)

- Provision of exchange and exchange access services and unbundled network elements constitute transactions requiring disclosure (See CC Docket No. 96-150, Report and Order, para. 124). These transactions include the provision of transmission and switching facilities by the BOC and its affiliate to one another. (See CC Docket No. 96-149, First Report and Order, para. 193)

- The separate affiliate must provide a detailed written description of the asset or service transferred and the terms and conditions of the transaction on the Internet within ten days of the transaction through the company's home page. (Note: a transaction is deemed to have occurred once the BOC and its affiliate have agreed upon the terms and conditions of the transaction, not when the service is actually performed or the asset actually sold (*See* CC Docket No. 96-150, Report and Order, para. 124)). The description of the asset or service and the terms and conditions of the transaction should be sufficiently detailed to allow evaluation of compliance with accounting rules. This information must also be made available for public inspection at the principal place of business of the BOC. The information made available at the principal place of business of the BOC must include a certification statement identical to the certification statement currently required to be included with all Automated Reporting and Management Information System ("ARMIS") reports. Such certification statement declares that an officer of the BOC has examined the submission and that to the best of the officer's knowledge all statements of fact contained in the submission are true and the submission is an accurate statement of the affairs of the BOC for the relevant period. (See CC Docket No. 96-150, Report and Order, para. 122)

- Section 272(b)(3) does not preclude an affiliate of the BOC, such as a service affiliate, or the parent company of both the BOC and its section 272 affiliates from performing functions for both the BOC and its section 272 affiliate. The affiliate transaction rules apply to transactions between the BOC and a nonregulated affiliate of the BOC, such as a service affiliate, and to transactions between the BOC and its parent company. Under the principle of "chain transactions," the affiliate transaction rules also apply to any transactions between the section 272 affiliate and a nonregulated affiliate of the BOC, such as a service affiliate, that ultimately result in an asset or service being provided to the BOC. (See CC Docket No. 96-150, Report and Order, para. 183)

- In the case of transactions for assets and services subject to section 272, a BOC may record such transactions at prevailing price regardless of whether the 25% threshold has been satisfied. (See CC Docket No. 96-150, Report and Order, para. 137; CC Docket No. 00-199, Report and Order, Appendix F, Section 32.27)

- Nondiscrimination requirements extend to any good, service, facility, or information that a BOC provides to its section 272 affiliate(s) with the exception of joint marketing, which is covered in section 272(g) of the Act. Unaffiliated entities must have equal opportunity to acquire any such good, service, facility, or information. In particular, if a BOC were to decide to transfer ownership of a unique facility, such as its Official Services network, to a section 272 affiliate, it must ensure that the section 272 affiliate and unaffiliated entities have an equal opportunity to obtain ownership of this facility. (See CC Docket No 96-149, First Report and Order, para. 218)

- Interstate rate base, revenue requirements, and price cap indices of the BOC must be reduced by the costs related to any regulated facilities transferred to each section 272 affiliate. (See CC Docket No. 96-150, Report and Order, para. 265; see also C.F.R. 61.45(d)(1)(v))

PROCEDURES

1. Document in the working papers the procedures used by the SBC BOC/ILEC to identify, track, respond, and take corrective action to competitors' complaints with respect to alleged violations of the section 272 requirements. Obtain from the SBC BOC/ILEC a list of all FCC formal complaints, as defined in 47 CFR 1.720; FCC informal complaints, as defined in 47 CFR 1.716; and any written complaints made to a state regulatory commission from competitors involving alleged noncompliance with section 272 for the provision or procurement of goods, services, facilities, and information, or in the establishment of standards which were filed during the engagement period. This list should also include outstanding complaints from the prior engagement period, which had not been resolved during that period. The list should group the complaints in the following categories:

    - allegations of cross-subsidies (for Objectives V and VI);

    - allegations of discriminatory provision or procurement of goods, services, facilities, customer network services information (excludes customer proprietary network information (CPNI)), or the establishment of standards (for Objective VII);

    - allegations of discriminatory processing of orders for, and provisioning of, exchange access and exchange services and unbundled network elements, and discriminatory resolution of network problems (for Objective VIII);

    - allegations of discriminatory availability of exchange access facilities (for Objective IX);

- allegations of discriminatory availability of interLATA facilities or services not at the same rates and not on the same terms and conditions as the interLATA affiliate (for Objective XI).

For each group of complaints, determine by inquiry and documentation how many of these complaints were under investigation, how many complaints had been resolved, and in what time frame they had been resolved, if feasible, and disclose in the report. For those complaints that had been resolved, document and disclose in the report how those allegations were concluded and, if the complaint was upheld, inquire and document and disclose in the report what steps the company has taken to prevent those practices from recurring. For all complaints that were filed in the previous engagement period, but were still open as of July 10, 2003, determine by inquiry and review of documentation how many of these complaints were under investigation as of the end of the current engagement period, how many complaints have been resolved as of the end of the current engagement period (and in what time frame they had been resolved), and disclose results in the audit report. For those complaints that have been resolved, document and disclose in the report how those allegations were concluded, and if the complaint was upheld inquire and document and disclose in the report what steps the company has taken to prevent those practices from recurring.

Note: Although applicable to complaints pertaining to Objective V/VI, VII, VIII, IX and XI, this procedure appears only once and will be performed only once for Objectives V/VI, VII, VIII, IX and XI. Reporting of the results of this procedure in the final report should be found here under Objective V/VI, Procedure 1, and should include the results for each respective objective.

2. Obtain from each SBC BOC/ILEC, and each section 272 affiliate, current written procedures for transactions with affiliates. Compare these procedures with the FCC rules and regulations indicated as "standards" above. Note and describe any differences and disclose in the report.

3. Inquire and describe how each SBC BOC/ILEC and each section 272 affiliate disseminate the FCC rules and regulations and raise awareness among employees for compliance with the affiliate transactions rules. For this purpose, describe in the report the type and frequency of training, if any, literature distributed, and company policy; document in the report the nature of the supervision received by employees responsible for affiliate transactions. Interview a representative sample of employees responsible for the development and recording of affiliate transaction costs in the books of record of the carrier to determine awareness of these rules. Disclose in the report whether these employees demonstrated knowledge of these rules.

4. a. Obtain a listing of all written agreements for services and for interLATA and exchange access facilities between each SBC BOC/ILEC and each section 272 affiliate which were in effect during the Audit Test Period. Note which agreements are still in

effect. For those agreements no longer in effect, indicate the termination date; identify agreements terminated prematurely and document why and disclose in the report. Inquire and document and disclose in the report the provisioning of any service without a written agreement.

b. Obtain a listing of all written agreements, amendments and addenda that became effective during the Audit Test Period. Tariffs and tariff amendments need not be included in this listing. For a statistically valid sample of such agreements, amendments and addenda, obtain (include in the practitioner work papers) copies of written agreements, amendments and addenda.

5. Using the sample of the agreements, amendments and addenda obtained in Procedure 4b, view each company's web site on the Internet and compare the prices, terms and conditions of services and assets shown on this site to the agreements provided in Procedure 4b above. Disclose in the report any instance where any item in the agreement does not agree with the corresponding item on the Internet. Using the same sample as above, obtain a list of the principal places of business (BOC headquarters) where these agreements are made available for public inspection. Using a judgmental sample of locations agreed to by the Joint Oversight Team, by physical inspection determine whether the same information is made available for public inspection at the principal place of business (BOC headquarters) of each SBC BOC/ILEC. Where such information is made available electronically via the Company's Intranet (internal corporate network), physically access such information at one location; for the remaining locations confirm that the Company's Intranet is operational and available to interested parties, and the certification statements are available for public inspection. Describe any differences and inquire why such differences exist and disclose in the report. If the company makes any claim of confidentiality for nondisclosure, obtain details. It should be noted that these transactions should be posted for public inspection within ten days of their occurrence. For each of the sampled agreements, amendments, and addenda, document in the workpapers the earlier of the date when the sampled agreement, amendment and addenda was signed or the date when the service was first rendered; also note the date of posting of the service on the Internet. Inquire and note in the report late postings and reasons when posting took place after ten days of the signing of an agreement or the provision of service (whichever took place first). Document in the working papers the procedures the company has in place for posting these transactions on a timely basis. The information provided on the Internet should be in sufficient detail to allow evaluation for compliance with accounting rules (see CC Docket No. 96-150, Report and Order, para. 122). Such disclosures should include a description of the rates, terms, and conditions of all transactions, as well as the frequency of recurring transactions and the approximate date of completed transactions. For asset transfers, the disclosure should include the appropriate quantity and, if relevant, the quality of the transferred assets. For affiliate transactions involving services priced at fully distributed cost or estimated fair market value, the disclosure should include the number and type of personnel assigned to the project and the level of expertise of such personnel (including the associated rate per service unit (e.g., contacts, hours, days, etc)). Service transactions should also disclose any special equipment used to provide the service, and

the length of time required to complete the transaction. Additionally, the disclosure should state whether the hourly rate is a fully-loaded rate, and whether or not that rate includes the cost of materials and all direct and indirect miscellaneous and overhead costs, for goods and services provided at FDC. If the information disclosed on the Internet is not sufficiently detailed as described above, document and describe in the report the total number of agreements that were observed with insufficient detail, and the particular item(s) not sufficiently detailed. Inquire of management and document in the report why such differences exist. (See CC Docket No. 98-121, In the Matter of Application of BellSouth Corporation, BellSouth Telecommunications, Inc., and BellSouth Long Distance, Inc., for Provision of In-Region, InterLATA Services in Louisiana; *Memorandum Opinion and Order*; Released October 13, 1998, para. 337.) Obtain copies of these public postings and include in the working papers.

6. Obtain a listing of all nontariffed services rendered by the BOC/ILEC(s) to each section 272 affiliate, by month, during the Audit Test Period. Determine which of these services are made available to both section 272 affiliates and to third parties.

   a. From the services not made available to third parties:

      1. Determine the 9 services/bill detail lines with the highest billing volume in dollars over the Audit Test Period (total SBC including all BOC/ILECs and all states) that were billed to the section 272 affiliates (total SBC including all section 272 affiliates). In addition, randomly select one service from among the remaining services for a total of 10 services to be tested. Randomly select three individual non-consecutive months during the Audit Test Period. For each month selected, obtain the billing records for all states, all BOC/ILECs, for the 10 "services to be tested" previously identified. Billing records should reflect the billing to all section 272 affiliates. For each of the 10 services to be tested, randomly select 10 billing transactions from the three months of billing records for a total of 100 billing transactions to be tested. (If there are fewer than 10 services not made available by BOC/ILECs to third parties, continue selecting billing transactions until 100 billing transactions are selected from the billing records. For each transaction, determine compliance with section 32.27 of the Commission's Rules. Compare unit charges to Fully Distributed Cost (FDC) or Fair Market Value (FMV) as appropriate. When differences exist between the amount recorded by the BOC/ILEC, the amount billed by the BOC/ILEC, and the amount to be charged in accordance with the affiliate transaction rules, note in the report the number of instances and related amounts, and, after inquiry, document in the report the reasons for these occurrences.

      2. For the sample of billing transactions selected in step 1, test each transaction for the proper application of billing rates, including all applicable discounts, surcharges, late fees, etc. Also test that the billed amount was paid by the section 272 affiliate. This can be accomplished, for example, by inspecting the Accounts Receivable record (may be a computer screen) that identifies the method

of payment such as check number(s), wire transfer(s), or any intercompany automatic settlement payment and/or treasury payment process, and, if needed, summaries of invoiced amounts corresponding to the amount paid. Obtain copies of relevant documents and records, e.g., screens, summaries, etc., for the work papers. When any differences exist, note in the report the number of instances and the amount by which each item is different than the amount required by the rules and, after inquiry, the reasons for these occurrences. Also test that the transaction was recorded on the section 272 affiliate's books and that the same amount was paid by the section 272 affiliate. Document in the audit report each instance where the payment by the section 272 affiliate was not properly recorded, and where any differences were found in the recorded vs. paid amounts.

b. From the services made available to both section 272 affiliates and to third parties:

1. Determine the 9 services/bill detail lines with the highest billing volume in dollars over the Audit Test Period (total SBC including all BOC/ILECs and all states) that were billed to the section 272 affiliates (total SBC including all section 272 affiliates). In addition, randomly select one service from among the remaining services for a total of 10 services to be tested.

2. Randomly select three individual non-consecutive months during the Audit Test Period. For each month selected, obtain the billing records for the 10 "services to be tested" identified in step 1. Billing records should be for all BOC/ILECs, all states, and reflect billing to all section 272 affiliates. For each service to be tested, randomly select 10 billing transactions from the three months of billing records for a total of 100 billing transactions to be tested. (If there are fewer than 10 services made available by BOC/ILECs to both section 272 affiliates and to third parties, continue selecting billing transactions until 100 billing transactions are selected from the billing records. For each billing transaction selected, test each transaction for the proper application of billing rates, including all applicable discounts, surcharges, late fees, etc. Also test that the transaction, including the subsequent receipt of payment or the equivalent, was properly recorded by the BOC/ILEC in accordance with the affiliate transactions rules and that the billed amount was paid by the section 272 affiliate. This can be accomplished, for example, by inspecting the Accounts Receivable record of the BOC/ILEC (may be a computer screen) that identifies the method of payment such as check number(s), wire transfer(s), or any intercompany automatic settlement payment and/or treasury payment process, and, if needed, summaries of invoiced amounts corresponding to the amount paid. Obtain copies of relevant documents and records, e.g., screens, summaries, etc., for the work papers. Determine if the transaction billed to the section 272 affiliate complies with section 32.27 of the Commission's Rules. When differences exist, note in the report the number of instances and the amount by which each item is less than the amount required by the rules and, after inquiry, the reasons for these occurrences. Also test that the transaction was recorded on the section 272 affiliate's books and that the same

amount was paid by the section 272 affiliate. Document in the audit report each instance where the payment of the bill by the section 272 affiliate was not properly recorded, and where any differences were found in the recorded vs. paid amounts.

7. Using the listing obtained in Procedure 6 of services rendered by month by SBC BOC/ILECs to each section 272 affiliate during the Audit Test Period, determine if any of the services rendered include operating, maintenance, or installation (OI&M) functions.

   a. Disclose in the report whether the SBC BOC/ILECs are rendering any OI&M services to each section 272 affiliate, and the date any such provision of service started. Disclose in the report whether any such OI&M services are or are not made available to third parties.

   b. If the SBC BOC/ILECs render OI&M services to any section 272 affiliate, determine the following and disclose in the report:
   - date affiliate agreement was effective (date signed);
   - date affiliate agreement was posted to the internet;
   - date each SBC BOC/ILEC filed its Cost Allocation Manual (CAM) amendments with the FCC, and the effective date of those CAM amendments.

8. Obtain a listing of all services rendered by month by each section 272 affiliate to each BOC/ILEC during the Audit Test Period.

   a. Randomly select three individual non-consecutive months during the Audit Test Period. For each month selected, obtain the billing records for all services that were billed to the SBC BOC/ILECs. Billing records should be for all BOC/ILECs, all states, and reflect billing from all section 272 affiliates. (NOTE: SBC LD can only identify billing to SBC affiliates; population cannot be isolated to BOC/ILECs only.) Determine the number of services that make up 80% of total billing dollars. From the three months of billing records, randomly select 50 bills from the section 272 affiliates to the BOCs/ILECs; if the bill selected is not billing to a BOC/ILEC, continue replacement sampling until 50 bills to BOC/ILECs are selected. Also review the sample to ensure that all BOC/ILECs and all states are represented; perform replacement sampling until this criterion is met. From the 50 bills select two billing transactions with different rates for a total of 100 billing transactions to be tested; if a bill does not have two billing transactions select a transaction on another bill with more than two transactions to ensure a total of 100 billing transactions. (The same service may have different rates due to state differences, interLATA usage, intraLATA usage, etc.) After selection of the 100 billing transactions to the BOC/ILECs, determine if the same services are represented in the sample as the services that made up 80% of total billing dollars; consult the JOT for approval of the sample.

   b. For each transaction selected, determine whether the amounts recorded for the purchase of the services in the books of the BOC/ILEC are in accordance with the affiliate transactions rules of the Commission (section 32.27). Compare unit charges to Fully

Distributed Cost (FDC), Fair Market Value (FMV), or prevailing market price (PMP) as appropriate. Also check any "chain" transactions. Chaining may occur when a section 272 affiliate provides an asset or service to a BOC/ILEC that was originally obtained from another nonregulated affiliate, including if the section 272 affiliate obtained a product or service that was used to create the asset or service being provided to the BOC/ILEC. In such chain transactions, the section 272 affiliate must charge the lower of FDC or FMV of the original nonregulated affiliate unless there is a prevailing market price. The costs recorded by the BOC/ILEC must reflect the actual costs the originating affiliate incurred in creating the asset or providing the service unless the originating affiliate had established a prevailing market price.[10] When differences exist, note in the report the number of instances and the amount by which each item is different from the amount required by the rules and, after inquiry, the reasons for these occurrences. Also disclose in the report the differences between the amount the BOC/ILEC has recorded for the transaction in its books of account, and the amount the BOC/ILEC has paid for the transaction to the section 272 affiliate.

c. For the sample of billing transactions selected in step a, test that the transaction was properly recorded by the section 272 affiliate, and that the billed amount was paid by the BOC. This can be accomplished, for example, by inspecting the Accounts Receivable record of the section 272 affiliate (may be a computer screen) that identifies the method of payment such as check number(s), wire transfer(s), or any intercompany automatic settlement payment and/or treasury payment process, and, if needed, summaries of invoiced amounts corresponding to the amount paid. Obtain copies of all relevant documents and records, e.g., screens, summaries, etc., for the work papers. Disclose in the audit report each instance where a discrepancy is found in the billing or recording of the billing of the service by the section 272 affiliate, and each instance where the payment of the bill was not properly recorded, or not recorded.

9. Using the balance sheet information for each section 272 affiliate and the detailed listing obtained in Procedure 6 under Objective I, for items added since July 10, 2003, perform the following steps:

a. For those items purchased or transferred from any SBC BOC/ILEC, obtain net book cost and fair market value. Inquire and document in the report how the fair market value was determined. Inspect these transactions to determine whether they were recorded in the books of the SBC BOC/ILEC at the higher of FMV or net book cost, as required by the Commission's rules in section 32.27 and disclose in the report.

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[10] *See* In the Matter of NYNEX Telephone Companies' Permanent Cost Allocation Manual for the Separation of Regulated and Nonregulated Costs, AAD 7-1678, *Memorandum Opinion and Order*, Released October 11, 1988, paragraphs 23-25; *see also* In the Matter of Implementation of the Telecommunications Act of 1996; CC Docket No. 96-150, Accounting Safeguards Under the Telecommunications Act of 1996, *Report and Order*, Released December 24, 1996, footnote 376.